Test: Basic Economic Concepts

Instructor's Version

Answers: Free-Response Questions

1. Price as a Rationing Tool

A. How does price ration scarce goods in a market economy? (3 points)

Answer:
Price discriminates between those who have money and those who do not. Prices allow scarce goods to go to the people who are willing and able to pay for those goods.

either sentence is fine for the full 3 points

B. An increase in price provides information about the relative scarcity of a good. What does it say? (3 points)

Answer:
An increase in price means a good is relatively scarcer.

C. An increase in price may be caused by either of two things. What are those two things? (3 points)

Answer:
A good may be more valued than it used to be, and there may be fewer resources available to produce the good.

2 points for one right, 3 points for getting both right

2. Suppose you're absolutely confident that you've misplaced a $5 bill somewhere in your neighborhood. How long will you search for that money? Explain your answer, using the concept of sunk costs in your explanation. (6 points)

Answer:
Depending on the value of your time, you will continue to search for the $5 as long as you expect to find it within a period of time that you value no more than $5. So, if you value your time at $20 an hour, you will search as long as you expect to find it within the next 15 minutes. At any point, the time you've already spent searching is a sunk cost and will not affect your decision to continue to search.

Key ideas: sunk costs are unrecoverable costs, 3 points; and search as long as expected benefit exceeds expected future cost, 3 points

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3. Supply and Demand

A. Assuming that coffee and tea are substitutes, show the effect that an increase in the price of tea will have on the market for coffee. Use a graph to answer the question. (3 points)

Answer:
An increase in the price of tea will increase demand for coffee, leading to higher prices and a greater quantity exchanged.

1 point for a graph with increased demand, 1 point for increased price, and 1 point for increased quantity

B. Explain why a change in the price of coffee might not change the demand for coffee. (3 points)

Answer:
A change in the price of coffee will cause movement along the demand curve, but will not shift the demand curve and change demand. This is because the demand curve is a relationship between price and quantity demanded.

1 point for saying that it will result in movement along the curve. 2 points for saying that the demand curve allows for changing prices of that good.

C. In an attempt to protect the lifestyle of domestic coffee workers, the government prohibits the importation of foreign coffee. Show the effect this has on the market for domestically grown coffee, using a graph. (3 points)

Answer:
This will increase the demand for domestically grown coffee, leading to higher prices and a greater quantity.

1 point for the graph with increased demand, 1 point for increased price, and 1 point for increased quantity.

D. In an attempt to protect the lifestyle of domestic coffee workers, the government prohibits the importation of foreign coffee. Show the effect this has on the domestic market for all coffee. (3 points)

Answer:
This will decrease the supply of coffee, leading to higher prices and a smaller quantity.

1 point for the diagram with decreased supply, 1 point for increased price, and 1 point for decreased quantity.

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4. Price Controls

A. Show in a diagram the effect of a law that imposes a minimum wage. What is the effect of this law? (3 points)

Answer:
This should be a standard price floor diagram resulting in a surplus of labor.

2 points for drawing the correct diagram. 1 point for stating that a surplus will result.

B. Show in a diagram the effect of a law that sets a price ceiling on the interest rate that may be charged on a loan. What effect does this law have on the market for loans? (3 points)

Answer:
This should be a standard price ceiling diagram resulting in a shortage of credit or borrowing.

2 points for drawing the correct diagram. 1 point for stating that a shortage will result.

C. What effect will these laws have on the quantity of labor exchanged and on the quantity of borrowing done? (6 points)

Answer:
Both of these will reduce the quantity exchanged in their respective markets.

3 points for each market.

5. Demand

Explain the difference between a change in demand and a change in the quantity demanded. You should be sure to mention what might cause each of these things and how each would be graphed. (6 points)

Answer:
A change in demand is a shift of the demand curve; a change in quantity demanded is movement along the demand curve. A change in the quantity demanded results from a change in the price of the good; a change in demand may result from just about anything else including changes in income, changes in the prices of other goods, changes in preferences, or changes in expectations about the future.

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3 points for each, with the 3 for each divided into: 1 for the source of the change, 1 for the graph description, and 1 for stating what the change actually means.

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